30 January 2012

The Manager
Corporate Reporting and Accountability Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

By Email: corporatereportingreforms@treasury.gov.au

Dear Sir / Madam

Proposed Amendments to the Corporations Act – Discussion Paper

William Buck is pleased to provide Treasury with its comments on the Discussion Paper 'Proposed Amendments to the Corporations Act'. William Buck's response reflects our position as auditors and business advisers to listed and privately held companies, and other businesses.

Our specific comments in relation to the Discussion Paper are set out in Attachment 1.

We would welcome the opportunity to discuss our views further, and if you wish to do so please contact me on (02) 8263 4000.

Yours sincerely
William Buck (NSW) Pty Limited

L. E. Tutt
Director

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Attachment 1

Test for Payment of Dividends

1.1 Background and Principles of Reform

We preface our comments in relation to the test for payment of dividends by noting that we applaud the motivation for the amendment of section 254T of the *Corporations Act, 2001* ("the **Act**") which occurred per medium of the *Corporations Amendment (Corporate Reporting Reform) Act 2010* ("**CACRRA**"). Such motivations included[1], *inter alia*:

— the long standing complexity, and hence uncertainty vis a vis the jurisprudential meaning ascribed to the ambit of the term "*profits*" of a company and the recognition that such meanings were often not aligned with current accounting principles;

— the introduction of IFRS reporting which, amongst other things, introduced the concept of transactions (often non-cash transactions) that formed part of "*other comprehensive income/expenses*" and hence increased the likelihood of 'debit reserves' being present as a component of 'shareholders' equity'; and

— the recognition that there has been a 'loosening' of the 18th century doctrine of capital maintenance. This development is a corollary of, amongst other things, the fact that in many cases the current shareholders of a company were not the same group of contributors of the initial capital of a company and hence the "protection' of such initial capital was less relevant as compared to, for example, a focus on the maintenance of the solvency of the company.

As such, we agree with the principle that the doctrine of "profits" is in many cases – but not all cases – inappropriate and fails to reflect current commercial reporting and dividend policy philosophy of both companies and shareholders. A simple example illustrates this motivation for reform:

	Company A	Company B
Share Capital	$1,000	$1,000
Retained Earnings/(Losses) 30 June 2010	($400)	$500
After tax 'profits' year ended 30 June 2011	$500	($400)
Retained Earnings 30 June 2011	$100	$100
Shareholders' Equity	$1,100	$1,100

Despite the obvious *prima facie* similarities of these two companies – e.g. both companies have equity of $1,100 including retained earnings of $100, the now repealed version of section 254T of the Act would seemingly have permitted Company A to determine (and declare) a dividend of $500[2] during the year ended 30 June 2011, while Company B could not have declared a dividend in excess of $100. Such a scenario seems absurd.

[1] Refer paragraph 60 of the Senate's Revised Explanatory Memorandum accompanying the introduction of CACRRA (the "**Explanatory Memorandum**").
[2] Refer, for instance, to principles enunciated in cases such as Glenville Pastoral Co Pty Ltd v FC of T 109 CLR 199 at 207 ("profits may of course be distributed by a company while a going concern even though a loss of paid up capital previously incurred has not been made good").

Thus, by way of background, we welcome any reform that is capable of achieving the desired effect of:

(a) providing a more "*flexible requirement*"[3] in terms of the ability for a company to pay a dividend to its shareholders where such payments have **in-substance** all of the commercially recognised indicia of being a distribution to shareholders of the 'benefits' which have accrued to the company over a period of time (i.e. non-capital amounts);

(b) recognising the diminishment in the capital maintenance doctrine; and

(c) aligning the income tax consequences of such distributions with the corporation law consequences of the distribution.

Having said this, we maintain that a substance over form approach must always be present. To this end we support an approach which, *inter alia*:

(i) maintains the current drafting of section 254T of the Act insofar as that section does not *authorise* any act: it merely *prohibits* some acts. Thus, under the current drafting of section 254T of the Act, a dividend may not be paid unless the company's assets exceed its liabilities and the other conditions are satisfied. That is not the same proposition that a dividend may be paid if those conditions are satisfied. In our opinion this position should be maintained. Thus we concur with the current drafting in terms of the continued presence, and need to comply with, Part 2J of the Act (subject to comments at point 1.5 below);

(ii) recognises that 'in-substance' returns of capital should **not** be classified as a dividend merely because the three (current) requirements of section 254T of the Act are satisfied[4]. Such in-substance transactions may be identified by way of, for example, a company debiting an equity account that had no opening balance - e.g. a '*dividend reserve account*' of the type considered in *Consolidated Media Holding v Commissioner of Taxation* [2011] FCA 367; and

(iii) importantly, recognises that there are now many instances where a company may have a debit/negative reserve account associated with, for instance, the presence of transactions forming 'other comprehensive income/expenses', and that the mere presence of such reserves should **not** impact on the calculation of "*profit*". That is say, a company which has both a current year 'profit attributable to members' *and* a genuine debit reserve account should continue to be able to determine and declare a dividend from such current year profits without fear of:

- breaching Part 2J of the Act; or
- having such dividend being treated as an unfrankable dividend for taxation purposes.

1.2 Current Drafting of Section 254T of the Act

For the convenience of discussion and referencing we have reproduced below the current drafting of section 254T of the Act.

Circumstances in which a dividend may be paid

(1) A company must not pay a dividend unless:

(a) the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend; and

(b) the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and

[3] Refer paragraph 62 of the Explanatory Memorandum.
[4] Moreover, such transactions should not, in our opinion, constitute a frankable dividend for taxation purposes.

(c) the payment of the dividend does not materially prejudice the company's ability to pay its creditors.

Note 1: As an example, the payment of a dividend would materially prejudice the company's ability to pay its creditors if the company would become insolvent as a result of the payment.

Note 2: For a director's duty to prevent insolvent trading on payment of dividends, see section 588G.

(2) Assets and liabilities are to be calculated for the purposes of this section in accordance with accounting standards in force at the relevant time (even if the standard does not otherwise apply to the financial year of some or all of the companies concerned).

1.3 Consideration of Options 1 to 4 as Outlined in the Discussion Paper

In short, we support **Option 4** as outlined in the Discussion Paper with modifications as referred to in the discussion below.

In our opinion this 'hybrid model' best achieves the stated objectives of the reform in relation to increasing flexibility in terms of the circumstances where a dividend is permitted and also provides increased certainty for companies of all 'sizes' and 'reporting regimes'.

In comparing the various models we contemplated a scenario as follows:

Table 1: Example

Account	$
Issued Capital	60,000
Asset Revaluation Reserve ('Authorised' under IFRS – referable to, for example, decrements in the fair value of a share portfolio not held for short term sale or hedging purposes. Assume opening balance of $13,000 and additional decrements in value of the share portfolio in the current year of $2,000)	(15,000)
After Tax Current Year Profit attributable to members (Balance **before** items of "other comprehensive income" - e.g. the additional $2,000 decrements in value of the share portfolio. Assume majority of profit is referable to dividends derived from the company's share portfolio. Further assume, no opening retained earnings.	10,000
Total Equity (Before any amount of dividend determined/declared)	**55,000**

That is say, we have considered a scenario where a company has net assets which are less than the amount of the company's share capital - due the presence of a debit (i.e. negative) reserve balance - but seeks to determine a dividend payable out of current year profits as ascertained before taking into account items of "other comprehensive income" (such as additional decrements in value of the share portfolio).

It is submitted that under this scenario, it is appropriate that the company should be able declare a dividend of $10,000 and the directors of the company should be confident that:

(a) there is no need to seek approval of the type prescribed by Part 2J of the Act; and

(b) such dividend can be declared as a fully franked dividend for taxation purposes.

This confidence should be based on the fact that the company, in this example, is merely seeking to 'pass on' the dividend income it has derived from its investments to its own shareholders. The ability to achieve this outcome should not be impugned by the fact that the value of the share portfolio has decreased and that this adjustment to fair value has been reflected as a separate debit/negative asset revaluation reserve.

In our opinion, Option 4 of the Discussion Paper provides maximum opportunity for this outcome to be achieved.

To further enhance the opportunity for this outcome to be achieved, **we strongly recommend** the Act should be amended (say with the introduction of a new sub-section 254T(3) of the Act) to prescribe that the term "*profit*" is to be determined **without** regard to amounts classified as being items of "other comprehensive income/expenses".

In further support for the introduction of Option 4 of the Discussion paper we note the following observations and benefits of this model of legislative drafting:

— to return to the comparison of Company A and Company B as outlined at point 1.1 above, Option 4 would provide both companies with the confidence that they could 'safely' declare a dividend of $500 (without regard to Part 2J of the Act – see separate comments at point 1.5 below) despite the fact that this would result in 'negative retained earnings' for both companies. Thus, the outcome under the former 254T of the Act would be maintained (via the *profits test*) while at the same time enhancing the flexibility of the company (via the *balance sheet method*);

— returning to the example at Table 1 above, Option 4 recognises that a distribution of up to $10,000 is 'in-substance' clearly a distribution of 'benefits' accrued to the company and hence has all the indicia and characteristics of a dividend as that term is commonly understood. This should be the case notwithstanding the presence of a debit reserve or the presence of $2,000 of 'other comprehensive expenses' (i.e. the devaluations that are not required to be recognised as 'profit/loss');

— maintaining the drafting of section 254T of the Act as a code for what is *prohibited* rather than what is *allowed* ensures that the solvency tests and other safeguard provisions of the Act are maintained. Moreover, we consider that the current drafting of sub-sections 254T(1)(b) and (c) should be maintained to enhance (or act as reminders of the presence of) sections 95A and 588G of the Act;

— by maintaining the *profits test*, companies can continue to rely, where required, on the substantial body of case law which has developed as to the meaning of the term 'profit'– especially where IFRS and other 'modern' accounting standards do not apply for the company and hence such legal precedent remains relevant; and

— as noted at page 9 of the Discussion Paper, Option 4, by way of the continued presence of the profit test, “avoids the burden that an assets exceeds liabilities rule places on companies that are not required to prepare financial statements”.

Comparison of Option 4 to Other Options in the Context of the Example at Table 1

Option	Observation
Option 1: Retaining section 254T as drafted	As identified on page 6 of the Discussion Paper, Option 1 would, in the context of the example at Table 1, create uncertainty where there are “*non-cash adjustments to fair value that are required to be reflected on companies’ balance sheets*”.
Option 2: Adopting a Solvency Test	We do not consider Option 2 has substantial merit under any circumstance. In particular, we note that this option seems to be substantially the same as Option 1 especially when regard is given to the fact that a “solvency test” already exists via section 95A of the Act. The only difference between Option 1 and Option 2 appears to be the reference for determining assets and liabilities – in this regard we refer you to our discussion at point 1.4 below.
Option 3: Reinstating the Profits-Based Test	While the “profits based test” provides an appropriate outcome for the example at Table 1 – provided the recommended clarification is made as the determination of “profits’ be excluding other comprehensive income/expenses – it would **not** provide the appropriate outcome in all cases and would perpetuate the anomalous outcome illustrated at point 1.1 above in relation to Company A v Company B.

1.4 Modification to Drafting of Section 254T(2) of the Act

In short, we consider that the current drafting of subsection 254T(2) of the Act is too onerous.

In our opinion, the comparison of assets to liabilities, for the purposes of the ‘balance sheet’ alternative proposed under Option 4 of the Discussion Paper, should be ascertained by reference to the most relevant ‘financial data’ of the company and should be aligned with the ‘degree’ of financial reporting that the Act otherwise ‘imposes’ on that company.

That is to say, for example, if a company is not required to prepare financial statements in accordance with all IFRS standards, then such IFRS standards should be not applied to determine the comparison of assets and liabilities.

Thus our recommendation would appear to be in accord with the ‘financial testing’ requirements outlined at Option 2 of the Discussion Paper and with paragraph 70 of the Revised Explanatory Memorandum accompanying the introduction of CACRRA which states:

“If a company is not required to prepare an audited financial report (for example, because it is a small proprietary company), then the first component of the test which requires the company to be balance

sheet solvent can be determined by reference to the accounting records which are required to be kept under section 286 of the Corporations Act."

1.5 Inclusion of an 'in-Substance' Requirement and Clarification in Relation to Part 2J of the Act

As mentioned above we recommend a drafting of section 254T which recognises that 'in-substance' returns of capital should **not** be classified as a dividend merely because the three (current) requirements of section 254T of the Act *or* the (proposed) profits test are satisfied. We recommend that consideration be given to the drafting of such a pre-requisite forms part of the re-drafted section 254T.

However, once this condition is incorporated into section 254T of the Act, then we further recommend that there should be a **codified** acknowledgement (or confirmation) that if all of the requirements of section 254T of the Act are satisfied then the approvals prescribed at Part 2J of the Act are not required. This will remove the current uncertainty which exists in relation to the 'inter-relationship' as between 254T of the Act and Part 2J of the Act.

Other Corporations Act Issues in Respect of the Dividends Test

Use of 'declared'

We offer no comments on this issue.

Capital maintenance requirements

As noted at the discussion at point 1.5 above, we do not share the view of Treasury, as expressed at page 10 of the Discussion Paper, that the "*legislative provisions are clear*". Rather, as indicated, we consider there is considerable doubt as to the inter-relationship as between 254T of the Act and the capital maintenance provisions at Part 2J of the Act.

We reiterate our recommendation at point 1.5 above that:

(a) an 'in-substance' capital maintenance test be added as an additional requirement of section 254T of the Act (applicable for both the profits test and the alternative balance sheet test); and

(b) codified acknowledgement (or confirmation) that if all of the requirements of section 254T are satisfied then the approvals prescribed at Part 2J of the Act are not required.

Adoption of this recommendation will remove the current uncertainty which exists in relation to the 'inter-relationship' as between 254T of the Act and Part 2J of the Act.

Application of test to group companies

We consider that the Act should **not** be modified to address the situation where an immediate holding company cannot satisfy the net assets test and, potentially stops dividends flowing to the parent company. Moreover, it is our opinion that the 'dividend tests' in the Act should not be modified for any aspect of 'group companies'.

In elaboration we note that:

- in our opinion such modifications would add unwarranted complexity to the Act;
- the Act should be capable of operating on a 'stand alone' company basis. To seek to modify the position for 'groups' would potentially pierce this 'corporate veil' and would create potential confusion for, as an example, a director of a holding company who was not also a director of the subsidiary (and vice versa); and
- stakeholders have become accustomed to 'dealing with' group scenarios.

Taxation issues

The Discussion Paper does not call for comments in relation to the interaction as between the corporation law aspects of declaring (and paying) a dividend and the taxation implications of such payments. We are aware that Treasury are obtaining 'feedback' on this matter via the comments being submitted in relation to Draft Taxation Ruling TR 2011/D8: *Income Tax: Section 254T of the Corporations Act and the assessment and franking of dividends paid from 28 June 2010.*

As such, we have not offered our opinions in relation to this matter in this submission.

Nonetheless, Treasury must be cognisant of the fact that any 'increased flexibility' in terms of the corporations law aspects of declaring a dividend that is *not* 'matched' in the ability to frank such dividends for taxation purposes will essentially render the reforms of section 254T of the Act as being impotent and of little value. In particular, it would be extremely 'embarrassing' from an international perspective that an Australian company could declare a dividend and yet it would not be possible to frank that dividend, with the consequence that such payments would be subject to Australian dividend withholding tax. Such a scenario would be detrimental to the encouragement of foreign investment.

Other Amendments

Parent entity reporting requirements

Inclusion of parent entity financial statements in consolidated financial statements
We support an amendment which allows entities that are required to prepared consolidated financial statements to also include parent entity financial statements and do not believe that any restrictions should be placed on the application of this proposed amendment.

Other parent entity financial statement related issues
We believe that further changes are required to section 295 (2) of the Corporations Act 2001 in order that non-reporting entities electing to prepare consolidated financial statements are not subject to reporting requirements that are more onerous than those applying to reporting entities.

As section 295(2) is currently worded there is some ambiguity regarding whether non-reporting entities are able to present only consolidated financial statements due to the terminology 'required by accounting standards'. Non-reporting entities are not required by Australia Accounting Standards to prepare consolidated financial statements, where consolidated financial statements are prepared it is an election the entity has made.

We believe that non-reporting entity's who elect to prepare consolidated financial statements should also be exempt from the requirement to present parent entity financial statements (unless they are required to do so by another governing legislation) where the entity has applied the consolidations accounting standards as if it were a reporting entity, that is in their entirety. A non-reporting entity that presents only consolidated financial statements should also therefore be required to comply with Corporations Regulations 2001 regulation 2M.3.01.

We believe section 295(2) should be amended to read as follow:

"The financial statements for the year are:
(a) unless paragraph (b) or (c) applies--the financial statements in relation to the company, registered scheme or disclosing entity required by the accounting standards; or
(b) if the accounting standards require the company, registered scheme or disclosing entity to prepare financial statements in relation to a consolidated entity--the financial statements in relation to the consolidated entity required by the accounting standards; or
(c) if the company, registered scheme or disclosing entity elects to comply with the accounting standards governing consolidations in their entirety--the financial statements in relation to the consolidated entity as prepared in compliance with the consolidations accounting standards."

Regulation 2M.3.01 should also be amended as a consequence of the above change.

Where a non-reporting entity does not comply with the consolidations standards in their entirety, for example they do not consolidate all entities over which they have either control, parent entity financial statements should be prepared as the consolidated financial statements are not a true reflection of the group position and will not provide financial statement users with all the information which may be required.

Changing the financial year of a company

We are supportive of this proposed change.